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A small step forward ...

Corporate Governance Rating 2003 for Polish Listed Companies

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Some sunbeams have broken through, at last. After a long period of the virtual negligence of corporate governance, some heralds of changes have appeared, spurring more deliberate and advanced arrangements in Polish listed companies. Some companies decided to introduce independent members to their supervisory boards and there are more information available at their web-sites. Insufficient as the changes are when compared with the needs, they remain positive impulses for the future. That is the shortest conclusion drawn from the results of the second edition of the corporate governance rating carried out by the Polish Forum for Corporate Governance.

Why rate companies?

The aim of the rating is to present in a comparative way an overall assessment of corporate governance arrangements: how public companies implement best practices and communicate with their shareholders. The position of a given company in the rating is supposed to reflect the level of risk in terms of the corporate governance arrangements. The higher the score, the internal regulations are more protective and reduce a risk of abusing (minority) shareholders. This, however, does not translate into permanent elimination of this risk. Shareholders and investors themselves must evaluate the management credibility and the companies' performance (practice) with respect to corporate governance. The position in the rating should not be in any case regarded as an assessment of the operational effectiveness of the company nor of its managerial team. In the extreme, it is possible that even a credible and transparent company goes bankrupt. Still, appropriate corporate governance arrangements should eliminate such dramatic developments in the long run. Thus we would like the rating to be a supporting tool for investors while evaluating particular public companies. The recent scandals (Enron, Cisco, Ahold, Parmalat and other cases) indicate that the price for taking corporate governance risk might be high. The PFCG rating is to assist the investors in differentiating among companies and appropriately discounting the risk. By the same token, the rating should produce economic incentives to encourage public companies to apply best governance standards. The rating does not encompass assessment of discrepancies (either in plus or in minus) between legal settings and the actual practice. It seems to be shareholders, and institutional investors in particular, that are best furnished to conduct such assessment. It could be valuable to supplement rating with such assessment, however it must be emphasised that it may be only a complement and not a separate measure as such as the evaluating parties may face conflict of interests concerning the undertaken or planned investments.

Results of the rating

The following public companies: Amica, Agora, BZ WBK, and Orbis scored best in the second edition of PFCG rating (see the table). When compared with the results from the previous rating, the group of leaders has been slightly enlarged. By all means, it is a positive signal. The corporate governance arrangements the leading companies apply, with respect to independent supervisory board members in particular, are quite advanced in comparison with the rest of the population and set the best practice to be followed. Only in the case of Orbis the supervisory board does not contain independent members, but representatives of minority shareholders elected by the means of cumulative voting. A considerable number of companies have upgraded their internal governance arrangements and reached a higher rating score.¹

¹ In the second edition of the PFCG rating the number of the companies being analysed was half the number of the 2001 edition, there being 50 largest in terms of capitalisation

Corporate governance rating 2003

(According to the status in November 2003; companies in the particular categories appear in the alphabetical order; the rating scale is from A to E)

Companies	Rating
Amica, Agora, BZ WBK, Orbis	A-
BPH-PBK, BRE Computerland, Eldorado, FORTE, KGHM, LPP, Netia, PEKAO, Polfa Kutno, PROKOM, TPSA, Stomil Sanok	B+
Dębica, Elektrim, Groclin, Impexmetal, INGBSK, Jelfa, Kęty, Kruszwica, Mennica, PGF, PKNOrlen, Polifarb CW, Rafako, Softbank.	B
Bank Handlowy, BIG BG (Milenium), Budimex, Comarch, Farmacol, EFL, Grajewo, Kogeneracja, Kredyt Bank, Krosno, Lentex, Mostostal SDL, Okocim, Orfe, Rolimpex, Sokołów, Sterprojekt.	B-
Cersanit, Echo, Hoop, Świecie, Żywiec.	C+

About the methodology

The rating is based on the analysis of statutes, internal regulations (by-laws) concerning functioning of supervisory and management boards and shareholders' meetings and content of the companies' websites. The very important source of information were the companies' declarations of compliance with the Warsaw Stock Exchange Code and especially the commentaries to particular rules. The adopted formula of the WSE code allows the companies' statements to have a purely declarative character. Hence, it is difficult to include them into the rating. Thus, in the case of the variables for which these declarations were used, it was important whether the standards were included in the statutes or other appropriate regulations (by-laws).

The assessment of the corporate governance solutions was based on the method elaborated for the previous edition of the rating (2001). The completion of the PFCG (Gdańsk) Corporate Governance Code and adoption of the WSE code have allowed the present rating to employ a greater number of variables in order to better describe the most prominent spheres of inter-corporate relations. All in all, there were approximately 60 variables grouped in 9 thematic indices which covered the following problems: the general characteristics of supervisory board (competence, number of members, etc.), the institution of the independent members, functioning of the management board, regulations concerning the general shareholders' meeting, strengthening the function of audit, exposition to the external control (i.e. the lack of defences against a hostile take-over), regulations on trading in own shares, companies' declared goals and intentions, transparency of information.

Cautiously towards independent members

The greatest weight in the assessment of corporate governance was attached to the regulations concerning independent supervisory board members – the institution being in our opinion the most important for outside shareholders protection. According to the recommendations of the PCFG code², a supervisory board should contain at least two independent members. Although the Warsaw Stock Exchange code³ recommends that at least half of a listed company's supervisory board should comprise of independent members, we believe that such a provision is going too far and is not practical⁴. Still, in our assessment, the latter solution was relatively highly ranked as it gives high powers to independent board members. As far as the assessment of independent board members is concerned, not only was the number of such members taken into account but also, and predominantly, the statutory criteria justifying their independence and the procedures of appointing and electing these members. In the latter respect, it was analysed whether or not the impact of the controlling shareholder over nomination and election process of independent members is somehow limited and whether or not a controlling shareholder has some privileges in these processes (which is the case in Agora having a majority of independent board members). As it was already mentioned, the independent members' powers were evaluated, too. According to the PFCG code, decisions on certain issues adopted by a supervisory board should required a "yes" vote from at least two independent members, however in the rating we scored also the arrangements requiring a "yes" vote only from one independent member. These sensitive issues requiring an approval form independent board members should include: auditor appointment, remuneration of the management, approval of party-related transactions and exclusion of pre-emptive rights whenever the additional shares are issued within the limits of the authorised (target) capital.

Although the institution of the independent board members has appeared in several companies, it is generally being approached with some reservations. Out of the 50 surveyed companies, only 12 had independent members in their supervisory boards, with 4 companies being still before instituting the relevant provisions in their statutes (BPH PBK and ComputerLand) or after the legal amendments but before election of such members for the first term (BRE and Forte). The number of the independent members seems more often to be determined according to the "minority solution", which is quite contrary to the Stock Exchange's recommendation but in accordance with that of the PFCG (Gdańsk) Code. The only companies which require or have more than half of their supervisory board constituted by independent members are Agora, BZ WBK, BRE, ComputerLand and Netia. However in case of Netia the statute stipulates the necessity of at least two independent members (they declare more as a current practice) while in BRE it is the general shareholders' meeting that finally decides on the number of such members. The other companies (Groclin, PKN Orlen, Amica, BPH PBK, and Eldorado) have introduced the "minority solution", meaning, generally, at least two independent members. Prokom introduced an exceptional solution with only one independent member in the supervisory board. Another interesting setting was applied by Forte, whose supervisory board is in 50% composed of independent members. With the even number of board members the decisive vote is however held by the chairman,

² Polish Forum for Corporate Governance has drafted a voluntary corporate governance code (so called the Gdansk Code) for Polish listed companies, see: <http://www.ecgi.org/>, <http://www.pfcg.org.pl/>

³ A few months after launching PFCG code Warsaw Stock Exchange has adopted its own code, see <http://www.ecgi.org/>, <http://www.gpw.com.pl/>.

⁴ The deeper argumentation for this might be found in our paper: Setting Standards of Corporate Governance: The Polish Experience of Drafting Governance Codes, published in European Business Organization Law Review 4/2003.

who is not an independent member by definition. This actually translates into a variant of the “minority solution”.

The most interesting manner of appointment and election of supervisory board independent members is that applied by Amica. The right to propose candidates for the independent members is held by the minority shareholders only, whose status is deliberately defined. During the election, each share carries one vote and additionally each shareholder (including the controlling one) may exercise no more than 5% of votes. It is pleasant to refer to the fact that this solution is based on the recommendation of the PFCG (Gdańsk) Corporate Governance Code.

It is a recurrent observation that the procedures of proposing and announcing candidates for supervisory board members before the general meetings of shareholders are poorly developed. Listed companies seldom assume or declare publicly the candidates before the general meetings of shareholders. Virtually never the companies present the candidates to the public early enough that it can be of importance to the shareholders, i.e. at least a fortnight before the general meeting. Only LPP approached the ideal, declaring that it will publish information about candidates for supervisory board members on its website 10 days before the shareholders’ meeting.

Supervision over party-related transactions

Apart from the independent members, proper supervision over transactions with affiliated entities is of crucial importance for sound corporate governance. Such transactions, made by controlling shareholders or management are particularly sensitive, with conflicts of interests very often involved and with risk present concerning value transfers out of the company at the expense of the minority shareholders. Unfortunately, the Warsaw Stock Exchange code neglects the problem – it only states – too broadly and generally – that such transactions should be conducted on market terms. A much more pragmatic solution would be to require the management board to obtain the supervisory board approval (including the consent of independent members) for any transactions with affiliated parties. Our analyses show that as few as 7 companies use a control measure of such nature, these companies being Agora, BZ WBK, Amica, Netia, Eldorado, EFL, and Prokom (the latter company, however, has instituted quite a high threshold from which the relevant transactions are being controlled). The ideal standard is almost reached by ComputerLand, too. In all others companies, there are no systematic and comprehensively prepared solutions applied in respect to transactions with affiliated parties, even though certain deals happen to be subject to the supervisory boards’ approval. In our opinion, a supervisory board should have precise information about whether or not transactions will take place between affiliated entities before approving them.

Shareholders meeting accessibility

The shareholders’ meeting is a key institution in providing balance among various shareholders’ interests and therefore it has to function in accordance with stable rules in order to provide a common ground for negotiating and achieving satisfactory goals. Thus the mode of convening and holding the shareholders’ meeting is of the utmost importance. It is especially important for proposing and removing motions to and from the agenda, dismissing the meeting and for the reliability of regulations which govern its proceedings etc. KGHM, Agora, Softbank, Amica, and BRE are most advanced formal regulation of the shareholders’ meeting proceedings (however BRE’s regulations include a controversial provision which

requires that the signature on the proxy document be confirmed by either a notary or bank's employee, which seems to be in contradiction with the appropriate rule of the official Stock Exchange code).

Generally, there are hardly any mechanisms which would facilitate the execution of proxies at the shareholders' meeting. The only exception is TP SA which provides on its website a template of the proxy document. Other examples of good practices with respect to shareholders' meeting are those of PGF and BPH PBK. The former company's general meetings are transmitted via Internet, whereas the latter one has undertaken to draw up two protocols after the general meeting, one of which consists of detailed minutes of the proceedings (subjects of discussion, motions, resolutions, etc.). Unfortunately, very rarely do companies' websites include a separate section devoted to the general shareholders' meeting and similarly seldom can shareholders obtain the materials for the meeting via Internet (e-mail).

Poor Transparency of Remuneration Arrangements

While evaluating the arrangements with respect to the management board, several factors have been considered – in particular: the definition and transparency of the remuneration policy, approval of the management board by-laws by the supervisory board and regulations concerning conflicts of interests and transactions with the company's shares. The lack of detailed information about the remuneration rules and remuneration policy seems especially worrying. Only few companies (Agora, LPP, TPSA, Comarch, Pekao, Polfa Kutno) display some basic information (which in fact is still too general) within the companies' corporate governance statements as required by the official Stock Exchange code. Still, the information in question is not available from the companies' websites. To some extent this is the effect of the way in which the appropriate recommendation of the Stock Exchange code is drawn up. It specifies in accordance with what principles the remuneration should be established but fails to compel companies to adopt the rules of transparency and to disclose the guidelines of their remuneration policy in more detail.

Auditor's independence

The variable referring to audit comprises the following factors: the supervisory board's actual powers as to the selection and appointment of the auditor, the limitations on the regular auditor to be appointed as a special auditor⁵, rotation of the audit firms, the acceptance process for providing other services by the audit firm, the existence of the audit committee, and finally the transparency of the rules concerning selection of the auditor, the scope of services conducted as well as the cost of audit and all remaining services.

The latter requirement has been fulfilled by none of the analysed companies. At the same time accessible information and corporate governance declarations fail to state precisely whether or not the companies are going to change the statutory audit firm regularly. Only PGF and Polfa Kutno declare to do so. In most cases, the companies declare to ensure the personal rotation of the auditor while preserving the possibility of extending the relation with the same audit firm. Only two companies (Jelfa and Okocim) have included appropriate records in their statutes.

⁵ Shareholder or shareholders holding no less than 5% of the total vote in the general meeting may resolve to have an expert (special auditor) which examine a specific issue related to the company's formation or the management of its business.

The rating was very strict about the manner of auditor selection and appointment. All situations in which the auditor was formally picked out by the supervisory board but, at the same time, was also the auditor of either the capital group or the controlling shareholder were appraised as suboptimal. These cases, described in the commentaries for the company's statements about compliance with the Warsaw Stock Exchange code, involved such companies as BZ WBK, Citi Handlowy, Kruszwica, Milenium (BIG BG), BRE, Budimex, Kredyt Bank, Świecie, EFL. The regulations and practices where the management board has considerable influence over the appointment of the auditor (Agora, Żywiec, Impexmetal, Rolimpex) were also treated as suboptimal.

Lack of anti-take-over defences

The index reflecting exposition to the external control has been based on the following variables: presence of dual class shares with respect to voting rights, voting caps and regulations stipulating "break through", granting at least two independent members with the decisive voice concerning the supervisory board decision on exclusion of the pre-emptive rights while issuing the authorised capital and presence of other anti-take-over devices (limiting the right to dismiss the management and supervisory boards, granting the right to propose candidates for the management board only to the holders of the certain class of shares, appointing the management board only by the general shareholders' meeting).

The lower value of the index of exposition to the external control translates into a higher level of anti-take-over defences, which results in poor influence of this important control mechanism over the company and its managers. On the other hand, it has been assumed that efficient anti-take-over defences may be of great importance to the company founders and in this way they may have positive influence on the company's functioning.

Websites resources

The most developed (with regard the number of variables) index of the rating describes the level of information available from the companies' websites. This has included the assessment of the following items: a separate section for investors, access to the major documents (by-laws) which regulate the functioning of the company and its bodies (including the statute), the scope of information about the members of the management and supervisory boards (particularly on the relations of the latter with the controlling shareholders), accessibility of the current, periodical and yearly reports. Surprisingly, many companies declare to comply with the Stock Exchange code (which requires providing many of the above mentioned information and documents), but still fail to include the appropriate internal documents on their websites.

The transparency index measures also the accessible evidence about the company's information policy and whether this policy is formalized, ideally in a document approved by the supervisory board, which regrettably takes place very rarely (the information in this respect was gathered mostly from the commentaries in companies' statement of compliance with the Stock Exchange code). It was also verified whether the websites include data about the structure of ownership and information about major shareholders as well as about the shares held by the members of management and supervisory boards or by other persons (founders, employees, etc.). The transparency index covered also the availability of companies declarations on compliance with the WSE code (only a 1/3 of the analysed companies published such a declaration on their websites) as well as individual sets of

corporate governance rules and arrangements (the only company to prepare one was TPSA). Amazingly, it is still possible to find even big public companies whose websites contain very limited information for investors and shareholders (with Żywiec controlled by Heineken being the extreme). One of the analysed companies (Frantschach Świecie S.A.) does not have a website at all!

Statement of goals and intentions

Finally a separate index of the rating assessed the definition of the company mission (goals) towards the shareholders. Here, the most valuable was a statutory record but merely one company (Amica) has incorporated such a record in its statute. A number of other companies define their mission towards the shareholders either on their websites or in a separate statement. Obviously, almost all companies declare to observe the 1st general rule of the Warsaw Stock Exchange code but hardly ever do the companies make more detailed declarations, e.g. by publishing financial forecast, expected dividends, etc. Only LPP's website contains the company's financial forecasts.